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**Learning through
Institutional Competition**

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Freiburger
Diskussionspapiere
zur Ordnungsökonomik

Freiburg
Discussion Papers
on Constitutional Economics



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Learning through Institutional Competition

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“Nothing is more favourable to the rise of politeness and learning than a number of neighbouring and independent states connected together by commerce and policy”
David Hume (1742/1985: 119)

1. Introduction

Why is it that the arts and sciences rose to such early and lasting heights in what is called “Western civilisation”? Why have schools, universities, academies emerged and progressed in various parts of Europe – and with them democracy, commerce, and the rule of law? David Hume was amongst the first to ask that question and provide an answer that relates to “mutual jealousy” between “neighbouring states” that are “connected together by commerce and policy” (Hume 1742/1985: 119). Greek antiquity provides an early example:

“Greece was a cluster of little principalities which soon became republics ... Each city produced its several artists and philosophers ... Their contention and debates sharpened the wits of men. A variety of objects was presented to the judgement, while each challenged the preference to the rest, and the sciences, not being dwarfed by the restraint of authority, were enabled to make such considerable shoots as are even at this time the objects of our admiration” (ibid.: 120f.).

According to this account two elements seem to have been most favourable to “sharpened wits of men” or, for that matter, learning: variety and liberty¹. One could even attribute the “sharpened wits” to only one causal factor that combines variety and liberty: competition. Competition as the peaceful rivalry and free mobility between a variety of free producers of arts, ideas, crafts, services, commodities, but also of laws, institutions and policies can be said to be a most distinctive heritage of European or (later) “Western” civilisation and has been argued to be a major explanation of “How the West Grew Rich” (Rosenberg/Birdzell 1986). Being neither historian nor anthropologist, I have to abstract from many aspects of history and “culture” in a wider sense (including habits, traditions, tastes, informal norms, values, arts and sciences). Rather, I will concentrate on favourable conditions for “political learning” in the sense of learning about the qualities of alternative potential legal-political solutions to

¹ Many other classical authors have noted the peculiar relationships between variety (political decentralization) and liberty in “old Europe” from Greek antiquity until the advent of nationalism during the 19th century. A recurrent account sees Europe’s geography as a primary condition that allowed only small and medium-sized jurisdictions to endure. Limited size coincided with limited government mainly because of the necessity to engage in inter-jurisdictional trade and market-friendly policies in order to attract fairs and merchants, but also artists and scholars who would find a variety of attractive neighbouring locations for employing their talents. Thus liberty may historically have been a by-product of competing variety which, in turn, was necessitated by geography. Roland Vaubel (2008) in his survey of the history of thought on institutional competition, refers to Hume, Montesquieu, Kant, Smith, Gibbon, Tocqueville, Acton, to substantiate this claim. Amongst present day scholars Jones (1981), North (1981), Berman (1983), Rosenberg/Birdzell (1986), Landes (1998), Volckart (2000), or Nemo (2005) point at very similar interrelations.

present-day social problems. And I will argue that competition between institutions (more specifically: between jurisdictions) provides, by ways of peaceful rivalry, an unequalled opportunity for learning about momentarily comparatively more adequate potential solutions to political-social problems.

The paper proceeds as follows: In **part 2**, I will discuss the ability of economic theories of competition to take the very phenomenon of learning into account. Neoclassical mainstream theories are able to address many aspects of competition (above all: static efficiency), but creative learning is mostly out of its reach. Therefore, I will turn to Austrian, especially Hayekian, views of “competition as a discovery procedure” in order to show important links between competition and learning. In **part 3**, I will lay out a first set of important peculiarities of *institutional* competition amongst jurisdictions. In a spirit of “consequent fallibilism” I will characterise institutions as hypotheses that always have to prove their adequacy in view of changing problem situations. Only based on this crucial assumption does learning by ways of trial and error become an important aspect of political life. Unlike in the realm of economic competition, institutions, however, appear on two distinct levels: not only as rules of the game that channel individual and collective choices *within* rules, but also as objects of individual choices *of* rules by ways of “exit”. In **part 4**, I will sketch the feedback-mechanisms between individual choices of institutions or “institutional arbitrage” on the “demand-“side, and collective choices of rules or “institutional entrepreneurship” on the “supply-“side. The capabilities of institutional competition to trigger learning processes in politics are discussed in **part 5**. Here, a major argument will be that “parallel experimentation” offers greater hope and scope for evolutionary learning than “consecutive experimentation”. In **part 6**, I want to highlight the virtues of institutional competition as a discovery procedure by comparing it to realistic alternatives (isolation, harmonisation and centralisation). **Part 7** provides a short outlook with reference to the future of European integration.

2. Competition as a discovery procedure and learning opportunity

The mainstream neoclassical approach to competition and other social phenomena can be condensed in one sentence as: “the combined assumptions of maximizing behavior, market equilibrium and stable preferences, used relentlessly and unflinchingly” (Becker 1976: 5). Such relentless combinations imply another assumption: “given knowledge”. And by assuming “given knowledge” or “common knowledge” the phenomenon of learning is

excluded from the area of investigation right from the start. To be sure, with the advent of the economics of information (e.g. Stigler 1961, Stiglitz 2000) “perfect information” no longer serves as a necessary companion to neoclassical economics. Imperfect and/or asymmetric information can be combined with stable preferences and maximising behaviour and still yield market equilibria. Learning in the sense of coping with true uncertainty and facing the potential of error and novelty, however, is something other than optimising ignorance based on given knowledge². Still, even imperfect information based on “rational ignorance” leads neoclassical price-theory to imply “imperfect competition” and various forms of “market failure”. The ideal of welfare economics – “perfect competition” – demands that homogeneous goods are given and knowledge about their properties is complete. Competition thus seems to be efficient and welfare-enhancing only in the economist’s Nirvana where there is nothing left to learn.

“Austrian” or evolutionary approaches are characterised by a more or less relentless rejection of Becker’s view. Maximising representative agents are rejected in favour of bounded rational individuals who differ in their knowledge, skills, expectations, practices and learning heuristics. Expectations and practices can even be wholly mistaken. Static equilibrium is rejected in favour of a process-analysis of spontaneous orders characterised by endogenous change based on the permanent creation of novelty, the competitive selection and the (often path-dependent) emulation of potential problem solutions which are not “given data” but changing options to be discovered in the process of competition. And with the emergence of novelty, endogenous change and interactive learning, stable preferences become a much more critical assumption that can hardly serve as an adequate starting point in many cases that are of interest – such as the case of learning.

It is above all with Hayek that a new view of the relation between “*Economics and Knowledge*” (Hayek 1937/48) emerged that centred on the phenomenon of a “division of knowledge” as “the really central problem of economics as a social science” (ibid.: 50). Economic agents are now assumed to base their individual plans on subjective expectations that reflect personal skills and local, partial knowledge which in its totality can never be known to any single mind. Economic coordination therefore takes place between individuals whose expectations about the behaviour of others are necessarily speculative, different and

² See e.g. Knudsen (1993) or Wohlgemuth (2005: 31ff.) for a critique of the optimizing calculus of “rational ignorance” based on marginal costs and benefits of an investment in new knowledge – the value of which can by its very nature not be known ex ante.

fallible, since they are based on only partial and conjectural knowledge about the social environment. Individuals always have to adapt to new circumstances that are permanently changed by processes of trial and error. In other words: social interaction involves permanent learning about new, subjective and ephemeral social “facts”.

“*The use of knowledge in society*” (Hayek 1945/48) thus is not to be seen as a learning-process in the sense of an increasing stock of “scientific” knowledge about historical facts or universal nomological relations of cause and effect. The knowledge relevant here “never exists in concentrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess” (ibid.: 77). With the division of knowledge a form of social learning becomes important that consists of innumerable actors’ successful adaptation to changing circumstances by ways of using knowledge that *others* have and that they themselves do not have to understand. Hayek’s prime example for such a somewhat “free-riding” use of knowledge is the price system as a “system of telecommunications” or “signals” (ibid.: 87) that allows market actors to adjust their subjective plans to a myriad of changes in the economic environment that affect the scarcity of goods and services, and thus to the dispersed knowledge of others that they never command themselves.³

“*The meaning of competition*” (Hayek 1946/48), in this context of a division of knowledge and its social use through price-signals, in important respects becomes the exact opposite of the neoclassical view of “perfect competition” based on “given” circumstances. If one could in fact treat preferences, knowledge and homogeneous goods as given “data”, competition would indeed become meaningless.⁴ The true meaning of competition is that of “a process of the formation of opinion ... It creates the views that people have about what is best and cheapest, and it is because of it that people know at least as much about possibilities and opportunities as they in fact do. It is thus a process which involves a continuous change in the data and whose significance must therefore be completely missed by any theory that treats these data as constant” (ibid.: 106).

³ See also Lachmann (1956: 21f) on the role of changes in relative prices which assist individual learning about new circumstances: “by observing price changes consumers learn which goods to substitute for which, and producers learn which line of production to abandon and which to turn to ... We may regard the price system as a vast network of communication through which knowledge is at once transmitted from each market to the remotest corners in the economy.”

⁴ Hayek later made the even more drastic point that: „if anyone really knew all about what economic theory calls the *data*, competition would indeed be a very wasteful method of securing adjustment to these data” (Hayek 1968/78: 179)

“*Competition as a discovery procedure*” (Hayek 1968/78) thus implies that “*wherever* the use of competition can be rationally justified, it is on the ground that we do *not* know in advance the facts that determine the actions of competitors ... it would clearly be pointless to arrange for competition, if we were certain beforehand who would do best” (ibid: 179). Thus, the need to learn is the main justification for competition. And enhanced learning is the main outcome of competition “as a procedure for the discovery of such facts as, without resort to it, would not be known to anyone, or at least would not be utilised” (ibid.).

For my purpose of analysing the possibility of “learning through institutional competition” a general assessment of competition is needed, very much like the one that Hayek portrays as “competition as a discovery procedure”. Such a general view would not have to be limited to the case of market competition and the price system, which are only parts of the overall process of institutional competition (see below). As major elements of an evolutionary view of competition as a process of discovery and social learning one needs only a few assumptions about individual behaviour and social life – which fortunately are much more realistic than those commonly used in mainstream economics. In addition, these assumptions hold for social behaviour in general – for economic as well as political rivalry and coordination.⁵

- (1) Individual behaviour: Human action, on markets as well as in politics or elsewhere outside the realm of irrational exuberance, metaphysical trance, or lovelorn remorse, is based on purposeful theory-guided expectations. The purpose is to achieve one’s own chosen ends (satisfy preferences) which may also include a purposeful regard for the welfare of others. Knowledge about the best way to achieve these ends is based on conjectures and beliefs (theories). These conjectures can be mistaken, they take the form of fallible hypotheses.⁶
- (2) Social context: If human action takes place in a competitive environment, the ability to achieve one’s own chosen ends depends on the reactions of others. These “others” are (a) those who voluntarily prefer one’s offered problem-solutions to alternative suggestions made by (b) competing providers of potential problem-solutions.

⁵ In other words, one does not have to use “bifurcated man” assumptions that would imply that someone who enters the political field would display standards of behaviour that differ from those she uses in economic transactions (see Buchanan 1972 on the methodological inconsistency of using “bifurcated man” assumptions).

⁶ See Boulding (1956), Vanberg/Buchanan (1989), or Wohlgemuth (2002), for a more thorough account of the methodological consequences of adding to preferences (goals, tastes: “what one wants”) theories and beliefs about the world and about how to achieve these goals (“what one believes”).

Competition, thus, is a permanent process of trying to persuade others to voluntarily prefer one's own proposed problem-solutions to those of others. It is not a state of rest or "equilibrium", nor can it be based on objective "maximising behaviour", because which and whose hypotheses will prove to be momentarily "right" and socially rewarded, changes and can not be known *ex ante*. It emerges from the process of voluntary interaction with likewise uncertain partners and "un-given" environments and thus cannot inform the same interpersonal process in a hypothetical state of given antecedents. If all facts that price-theory assumes to be given and known were in fact given and known, competition would indeed be a most superfluous and wasteful method of securing adjustment to these "given" facts. Only if there is no permanent and pre-known "truth", only if there is something to discover and something new to learn, does competition make social sense. And since one can have no *ex-ante* preference for something that one can only aspire to discover and learn, even the comfortable assumption of "given preferences" becomes unsuited for an assessment of the relationship between competition and learning. In short, the mainstream approach based on "the combined assumptions of maximizing behavior, market equilibrium and stable preferences" (Becker, *op. cit.*) may have many advantages. But as a starting-point for exploring "learning through competition" it does not allow us to account for learning processes as they unfold in real life.

3. Institutions as objects of individual choice and as rule of the game

Similar statements about the inadequacy of neoclassical economics to account for evolutionary properties of market competition have often been made. In addition to the Hayekian insight of the use of (more or less given) dispersed subjective knowledge, (Schumpeterian) creative entrepreneurship needs to be added to those elements that the neoclassical mainstream is ill-equipped to deal with. Both elements: the discovery of dispersed knowledge and the creation of new knowledge are, of course, central elements of any theory of learning. Learning involves both the discovery and communication of facts and theories that are "better" and the creation of ideas that may turn out to be "better". The criterion for "better" or "worse" is rather easily identified in the realm of individual voluntary transactions on the market place: the customer is "king" – whatever he "buys" according to her "consumer's sovereignty" is "better" according to his theories about what best satisfies her needs. Market competition based on un-coerced choices and entrepreneurial creations produces both the spontaneous *adaptation to variety* (of preferences, opinions, capabilities

etc.) and the spontaneous *creation of* variety (new potential problem-solutions for new potential needs). Both are prerequisites for learning.

There are important differences between typical market competition and inter-jurisdictional competition, to which I will turn in the next section. Still, institutional competition can be, quite like market competition, reconstructed as a “discovery procedure” and unique occasion for social learning processes. I define “institutions” for the purpose of the present task as rules of behaviour that are enforced by various sanctioning-mechanisms within a given group of people. In the process of competition between (realms and suppliers of) institutions, such rules relate to two different levels: (a) as objects of individual or collective (political) choice and (b) as rules of the game defining legitimate procedures and objects of individual or collective (political) choices. I will return to this crucial distinction in due course. First, I want to stress the fallible, conjectural character not only of human action, but also of institutions as human creations: on both levels – as inter-jurisdictional rules of the game that define how jurisdictions and rules can be individually chosen and as domestic rules that might be individually chosen.

Institutions play a crucial role in stabilising expectations of uncertain actors, thus reducing transaction costs and making mutual gains from trade with others more likely (e.g. North 1990). But any collective decision about *which* rules in *which* kinds of combinations with existing formal and informal rules are most adequate for *which* groups of citizens under *which* changing conditions, is confronted with formidable knowledge-problems. Such things can never be completely and conclusively known – neither to an enlightened benevolent dictator (or: economist) nor to “the sovereign” in a democracy: the majority of citizens. Based on that simple, but fundamental Popperian insight, Albert (1986: 40ff) calls for a “consistent fallibilism” which should not only apply to scientific hypotheses, but also to political attempts to solve collective action problems. In terms of a procedural social technology, consequent fallibilism or “rational problem-solving behaviour” (ibid.) calls for competition in the sense of the creation and comparative evaluation of realisable proposals for the solution of social problems offered by various groups and political “entrepreneurs” (ibid.). This is the basic rationale for learning through institutional competition (see part 5).

But which kinds of proposals can be effectively, legally, realised and which criteria for their evaluation and final implementation should be applied, depends on the rules of the game of

collective decision-making. Very much in the way that workable competition in the realm of economics (or of science) depends on the general acceptance of procedural rules of conduct, the workability and effectiveness of institutional competition as a learning device depends on the rules of the game. Of course, these institutions on a procedural level, as rules of the game of inter-jurisdictional competition or of an inter-jurisdictional “Wettbewerbsordnung”, are just as conjectural and fallible as are the intra-jurisdictional institutional hypotheses themselves. However, combining a constitutional economics “consent” test and some Austrian economics insights into the preconditions of competition as a discovery procedure, one can arrive at some plausible suggestions about which kinds of rules of the game of institutional competition would be most suited to allow for experimentation and learning in a way that should be in the common constitutional interest of sovereign citizens.

As Hayek and others⁷ have argued, both inter-personal justice and the workability of competition as a discovery procedure are best served under rules of the game that pass a “test of universalisability”. This is a procedural “test of the appropriateness of a rule” (Hayek 1976: 27) with the main criterion for appropriateness being whether we “can ‘want’ or ‘will’ that such a rule be generally applied” (ibid.: 28). Applying this Kantian test to the principles of a legal order, Hayek (1966/67:166) distinguishes 3 essential and interrelated aspects of rules of just conduct:

- (1) The rules should refer to concrete individual and political behaviour, not to states of affairs that no one could intentionally have brought about.
- (2) The rules would in most cases be prohibitions aimed at the prevention of unjust action⁸.
- (3) By prohibiting non-generalisable, discriminatory acts, the rules create protected domains that allow legally equal citizens to pursue self-chosen ends by choosing among an open set of actions that are not prohibited.

With respect to the discussion of international governance (e.g. Rodrik 1997, Rawls 1999), these criteria can yield some guidance. It implies that it would be broadly pointless to discuss globalisation or institutional competition in terms of market results such as the distribution of incomes across countries or regions or “terms of trade”, as long as they are the unintended results of spontaneous interactions between millions of individuals, which no one could ever

⁷ See Vanberg (2006) for a systematic account of the concepts of common constitutional interests and “citizen sovereignty”. See also Buchanan/Congleton (1998) and Berggren (1999) on the relationship between common constitutional interests and the formal principle of “generality” or “universalisability”.

⁸ The same is true for Kant’s famous articles on perpetual peace. All, Kant observes, “are prohibitive laws” requiring the abolishment of the stated abuses (Kant 1795/1991: 97).

have produced (or prevented) by deliberate action. Instead, one would have to look for concrete behaviour on the part of economic or political actors that can be argued to be unjust because it does not pass the test of universalisability, since no one (including those who carry out these acts) would want this kind of behaviour to be *generally* applied. Protectionism provides the perfect example. Tariffs and quotas, as well as cases of deliberately erected non-tariffs barriers to trade will be ruled out by the generality test as prejudicial to the myopic interests of specific groups.

The most important rules of just behaviour in an international community of free nations would have to bind *political* agents. They would above all consist of prohibitions of certain *political* actions that obstruct citizens' freedom to engage in mutually beneficial trade with foreigners. To be sure, the removal of barriers to the free movement of goods, services, capital and persons across borders need not be the only task of an international economic order. But it is the foremost task, since without negative guarantees of free trade the market order is not going to develop into an extended abstract order that allows individuals across borders to pursue their self-chosen aims in a regime of mutually beneficial exchange⁹. Other political rules that could facilitate international trade – such as the legal enforcement of border-crossing contracts, or the introduction of international standards and norms – are clearly secondary to the establishment of free trade. In addition, it is far from obvious that these

⁹ In Wohlgenuth/Sideras (2004) we argue that the European Union offers both a prime example and a major refutation of an ideal of a competitive “interstate federalism” based on universalisable rules of just (government-) conduct, as was early envisaged by Hayek (1939/48). Already in the 1958 treaties creating the European Economic Community, one finds the crucial universalisable rules governing the conduct of member state governments: the prohibition of barriers to trade between member states and the “abolition of obstacles to freedom of movement for persons, services and capital”. Prohibitions also include member states’ granting of privileges in the form of aids, subsidies, discriminatory taxation and regulation. In addition, private restraints to trade are “prohibited as incompatible with the common market”. Hence, the freedom to act and to compete *within* the common market is protected by universalisable rules of just conduct against interference of national governments and of private actors. At the same time, individual member states, as long as their actions are not prohibited as incompatible with the common market, are free to develop institutional systems that reflect their own social and economic condition, cultural tradition and public opinion. This inter-jurisdictional competition can in fact provide, as Hayek (1939/48: 268) expected, a “salutary check” on the states’ interventionist endeavours while still allowing or even stimulating “desirable experimentation”. On the other side, European integration also clearly contradicts Hayek’s expectation that interstate federalism would discourage discriminatory regulation and purpose-oriented legislation. Discriminatory laws and policy prescriptions can be found right at the beginning of European integration (e.g. the common agricultural policy or European Coal and Steel Community). And they have grown ever since, demanding a “high level of protection” in health, safety, environmental and consumer protection policies or the establishment of redistributive funds introduced by the Single European Act; ambitious industrial policy targets added by the Maastricht Treaty; or a verbose declaration of aims and purposes in the fields of “social policy, education, vocational training and youth” added with the Amsterdam Treaty and the present “Reform Treaty”. (see Wohlgenuth 2008).

elements of international private law would necessarily have to be laid down and fixed *once and for all* by an *international political* authority.¹⁰

4. The processes of institutional competition

Evolutionary market competition can be analysed as a compound of two interrelated processes, linked by feedback mechanisms, the power of which depends on the actors' incentives and willingness to invest in information (Streit/Wegner 1992): a selection process driven by choices on the demand side and a process of rivalry between (potential) suppliers of alternative problem-solutions. In its general structure, this concept also describes competition in a democracy with voters selecting between parties and candidates and political rivals competing for attention and votes, triggered by gain-and-loss feedbacks, the quality of which depends on the information costs that the actors are willing to invest in. In their substance, however, economic and political processes of selection and rivalry differ considerably.¹¹ I will now discuss some differences between economic market competition and political competition. At the same time, I will distinguish competition for mandates in a purely representative democracy and inter-jurisdictional rivalry for mobile resources which combines elements of economic selection processes ("exit") with those of political rivalry ("voice")¹².

Institutional choice

In both politics and the market, the intensity of competitive selection and the prospects for discovery and learning during the process critically depend on the freedom of the actors on the demand side to choose, using their individual knowledge and pursuing their individual goals. And the citizens' propensity to invest in information, to potentially "learn", critically affects the intensity and quality of the selection processes. The more substitutes with differing

¹⁰ In fact, border-crossing transactions within the "international private law society" (Sally 2000: 111) do rely quite comfortably on "a web of private property rights and the enforcement of contracts according to private law *within a multitude of separate national jurisdictions*" (ibid.). International trade flourished well in the absence of unitary private law and of a central enforcer of international contracts. In addition to the choice of national formal private law and jurisdiction, informal, privately-established and enforced norms and conventions governing international transactions have for centuries spontaneously evolved and supported the extending order of global capitalism. Obviously, this unplanned evolution of an order of rules establishing "stability of possession, of its transference by consent and of the performance of promises" (Hume 1739/1978: 126), originating in the mercantile community and spreading across borders of provinces and states by imitation rather than deliberate design is a major vindication of Hayek's trust in social self-organisation.

¹¹ See Wohlgemuth (2003) for more details.

¹² See Hirschman (1970) for the classic treatment of "exit" and "voice" as responses of citizens to a decline in performance of suppliers on markets and in politics.

price-quality combinations can be chosen according to individual preferences and needs, the more are actors on the demand side exposed to high-powered incentives and opportunities to discover these differences.

With regard to these aspects, political competition most clearly fails to provide convincing equivalents to normal market competition. A consumer of market goods receives only the goods she prefers and for which he is willing to pay. A political subject receives a complete bundle of political goods and services, regardless of personal preferences or any reciprocal action. Voters for the winning coalition, voters for losing parties and non-voters equally end up with the same election result and have to accept the same policies. Not surprisingly therefore, incentives to search, store and interpret information about political offers (programmes, candidates), political products (laws, regulations) or political systems (rules of the game) are low. This lack of high-powered incentives for knowledge-creation reduces the ability of the political selection process to discover comparative qualities of political alternatives. In addition, general elections do not *continuously* signal citizens' opinions on *particular* policies. They are only capable of voicing bold aggregate judgements about bundles of promises as incorporated in parties and candidates – and changing their relative political power positions every four or five years.

It is here that inter-jurisdictional competition differs from purely representative democracy. Institutional competition is based on *individual* choices of jurisdictions that provide alternative (bundles of) rules by way of exit of mobile resources across borders¹³. Exit entails the individual choice of rules instead of a collective choice of rulers. It is based on individuals' comparative appraisals of the net benefits when combining their mobile resources with various existing political infrastructures in different jurisdictions. Using exit, individuals can free themselves to some extent from forced consumption of political goods. As an ongoing selection mechanism, exit is therefore much more likely to provide political analogues to evolutionary market competition and the discovery and use of local knowledge.

¹³ The realization of choice options by way of “exit” is not necessary for institutional competition to trigger at least some learning effects. Comparative performance evaluation across jurisdictions can also help to inform and strengthen citizens' “voice” and thus limit monitoring and agency problems of comparatively ill-informed voters. Such “yardstick competition” can, even in the absence of realized “exit”, serve as a device to discipline rent-seeking politicians (Besley/Case 1995) and to promote policy innovation (Rincke 2005). However, yardstick-competition and exit-based competition should not be regarded as substitutes, but rather as complements that mutually reinforce each others' thrust. The effectiveness of yardstick competition certainly also depends on the collective *availability* of exit-*options* and the individual decisions whether or not to use these exit-options is based on comparative performance evaluations of citizens who face clear incentives to invest in comparative institutional analysis according to their own individual “yardsticks”.

By confronting actual (and not just potential) political alternatives, institutional competition communicates political preferences much more concretely than general elections. It provokes political opinion formation focused on concrete institutional alternatives, thus leading to the creation and social use of political skills and knowledge in society. Compared to market competition, the selection processes of representative democracy are poorly equipped to discover individual opinions and satisfy individual preferences according to their diversity, intensity and variability.¹⁴ The choice options of individuals within the process of institutional competition are centred somewhere between typical market competition and general elections. Institutions have no individual price-tags attached to them. They are not auctioned on a daily basis on a specific “market”. Hence the use of knowledge about institutions is not directly built on a division of knowledge that can be abstractly communicated by ways of changes in relative prices. By deciding to invest one’s capital or labour in a different jurisdiction, one is usually forced to choose a complete bundle of institutions for which one has to pay a more or less fixed overall “price”: taxes. The possibilities of “cherry picking” – choosing specific institutions of a foreign country while retaining others of one’s home country, are limited. And the possibilities of “free riding” – using foreign local public goods while not paying for them, should be limited.

As a consequence, exit or „institutional arbitrage“ (Wohlgemuth 1995: 282ff) sends out abstract and often diffuse signals about the institutional preferences of owners of mobile resources. These signals do not directly and undisputedly tell suppliers of institutional frameworks how to react. The signals have to be interpreted and successful (new) strategies have to be envisaged. This is the formidable task of political entrepreneurs.

Institutional entrepreneurship

The main motivation of politicians is to acquire or retain power, prestige and income. For that task, institutional competition is only relevant as far as it affects a politicians’ (party’s) prospects for (re-)election. In the end only the home-market for votes is relevant for domestic politicians and thus for the supply of institutions in a democracy. But inter-jurisdictional

¹⁴ To be sure, these comparative shortcomings are not ‘policy failures’, but mostly the necessary consequences of collective action in general and of democratic decision-making under the rule of law in particular. Equality before the law and quality of the law both demand that laws, regulations and political favours are not ‘exchanged’ in a market-like fashion. Such activities as one usually welcomes on markets attain negative connotations (favouritism, bribery) on political ‘markets’.

competition does affect this market in various ways: (a) the withdrawal of mobile resources reduces the productivity of immobile factors. Ensuing income losses of owners of (relatively) immobile resources can lead them to withdraw their support for the government. Especially the “exit” of capital investments and high-skilled labour has a negative impact on national income and employment – both crucial factors of empirically tested “popularity functions” of governments (e.g. Nannestad/Paldam 1994). In addition, the withdrawal of valuable resources as a tax-base has a negative impact on the governments’ budget and hence its ability to please voters with government transfers and expenditure programmes.

Very much like entrepreneurs on markets for private goods, political entrepreneurs face the difficult task of identifying the often complex causes of their “customers’” reactions and finding adequate responses. And as with competition in general, simple imitation of the behaviour of more successful rivals is no guarantee for success. The political entrepreneur’s task is even more demanding, since simple institutional emulation often creates frictions and inconsistencies within grown political-legal systems and traditions that display a high degree of functional interrelatedness. Successful political entrepreneurship would therefore very often not consist in imitation of one “golden” solution, but in institutional innovation, the creation of new problem solutions that can be more easily adapted to the specific legal-political structures and socio-political needs of the jurisdiction to which they should apply (see also Mukand/Rodrik 2005).

Market competition based on un-coerced choices and entrepreneurial creations enhances both the *adaptation to variety* (of preferences, opinions, capabilities etc.) and the *creation of variety* (new potential problem-solutions for new potential needs). The same is true for institutional competition. And this is a major reason why models of institutional competition that are based on strict neoclassical equilibrium assumptions, are inadequate to account for innovation and learning as major advantages of inter-jurisdictional competition. In Charles Tiebout’s (1956) famous model, only the adaptation to given alternatives is discussed. Here “exit” leads, under strong assumptions (e.g. perfect information), to an efficient allocation of given local public goods, because citizens with heterogeneous preferences move to jurisdictions that best fit their given preferences. Competition between jurisdictions thus results in homogeneous communities, with residents who all value public services similarly. In this sorting equilibrium, no individual can be made better off by moving, and the market is efficient. The “supply” of policies remains constant, only the mobile constituency re-allocates

itself efficiently. Other neoclassical models that look at the reactions of political suppliers to the threat of exit also assume given and known alternatives and given and known knowledge about their attributes. Depending above all on the initial assumptions, a “race to the bottom” or “race to the top”, ending in an equilibrium of “ex-post” harmonisation of policies across jurisdictions is deduced and compared to given “ex-ante” states of affairs or ideal states. Again, these models are not without merit. But they are unsuited for the purpose of discussing learning through (institutional or any other kind of) competition¹⁵.

5. Learning through institutional competition

Above, I have introduced the notion of institutions as fallible hypotheses concerning ways to secure beneficial coordination and control in human interaction. Critical-rational learning depends on continuously challenging (falsifying) “given” theories by creating alternative hypotheses. In some respects, the need for the creation of variety is even greater with what one could call “institutional fallibilism” than in the realm of critical-rational science. Nomological scientific theories mostly claim universal validity and falsifiability independent of time and place. Political “theories” – ideas about which policies are most adequate to solve collective action problems – are much more contingent. They can hardly be “true” once and for all. Thus, political learning is not about finding one eternal and universal “truth”, but about discovering temporarily more suitable solutions to changing problems of groups with different preferences and capabilities. And it is here that variety becomes especially important: “Only when a great many different ways of doing things can be tried will there exist such a variety of individual experiences, knowledge and skills, that a continuous selection of the most successful will lead to steady improvement” (Hayek 1978: 149). Political entities quite naturally fail to support variety on the level of goods and services provided. This is not by itself to be decried as “policy failure” since the tasks of the protective state (rule of law) and most tasks of the productive state (provision of public goods) require quite some intra-jurisdictional uniformity when it comes their application and enforcement. Most political goods and services are valuable precisely by virtue of their being the same for all citizens within a jurisdiction and their being changed only discontinuously.

At the same time, the variety of trials, together with an effective selection of errors are necessary conditions for the discovery of problem-solutions that are regarded superior by their

¹⁵ See below and Wohlgemuth (1995) for further details.

users. Democracy does introduce variety, but mainly on the level of proposals rather than that of final products (laws, regulations). This restriction of the realm of actual competition limits the evolutionary potential of political competition within a jurisdiction, because in each jurisdiction or ‘natural’ monopoly of government, there is only one set of political problem-solutions being tested at a time. Political evolution within these bounds is basically limited to learning from *consecutive* trials and errors (Vanberg 1993: 15f). By introducing “potential competition” from non-incumbents, democracy does create a variety of ideas and contestability of the status quo. But potential rivals make no actual contribution to an ongoing process of effective trial and error, and hence to a process of knowledge-creation based on actual comparative performance.¹⁶ In this context inter-jurisdictional competition displays its major virtue as a “discovery procedure”. By enabling citizens to actively choose between concrete sets of political alternatives institutional competition triggers a politically effective form of *parallel* rather than of consecutive learning from *real-life* experiences.

Our lack of knowledge about the respective working properties of policies and institutions and the increasing depreciation of our knowledge in the face of changing environments is thus the prime argument in favour of inter-jurisdictional competition (and not, as our neoclassical friends tend to argue: a prime argument against it). If all the problem-solving qualities of institutions and policies were known once and for all, institutional competition could justly be regarded as a wasteful (transaction-cost laden) method of discovering what we (as economists or politicians) claim to know already. This critique applies to neoclassical opponents *and* to defenders of institutional competition. Both presume to know the equilibrium outcome based on models with given preferences, given alternatives and given knowledge. In the first class of mechanistic models inefficient solutions crowd out the given efficient one(s) (“race to the bottom”); in the second the one known optimal solution is finally selected. Both models come close to our perfect competition stationary equilibrium model; often the only difference is that in the first case one starts with a perfect set of institutions and omniscient benevolent dictators, in the second, one usually assumes a rotten and corrupt Leviathan¹⁷. But in both

¹⁶ This argument is neglected by neoclassical models of both ‘contestable markets’ (e.g. Baumol 1982) in industrial economics and ‘efficient political markets’ in the Chicago Public Choice literature (e.g. Wittman 1995: 23). Both claim that ‘potential competition’ or the threat of entry can lead to results that are exactly equivalent to those to be expected under polypolistic competition – which is true (only) based on the models’ assumptions which exclude learning processes by treating all knowledge about alternatives as given.

¹⁷ For models that show a “race to the bottom” from the peaks of benevolent omniscient governments see e.g. Hans-Werner Sinn (2003) and the critique provided by Vaubel (2008). For a “Leviathan”-assumption based argumentation, see e.g. Stefan Sinn (1992).

cases the competitive process has no meaning as a discovery procedure nor as a permanent incentive structure to trigger learning and innovation.

Again, institutional competition is above all a most useful procedure if we acknowledge politicians' and citizens' constitutional lack of knowledge concerning present and future social problems and adequate political responses. In addition, decentralisation and inter-jurisdictional competition are the only ways to account for the fact that citizens have different and changing preferences also concerning the institutions and policies that they will have to finance and endure. Institutional competition is no equaliser or "ex post harmoniser". It is a permanent process of creating, comparing and adopting different responses to different needs, capabilities, and preferences.

Such political learning processes naturally take time, and they need time in order to be based on analytical insight and emerging political consent. Instantaneous adaptation and perfect mobility are elements of a misleading "perfect competition" Nirvana. Gradual adaptation and "loyalty"-based inhibitions of immediate "exit" are not to be deplored as indicators of "imperfect competition"; they rather serve as necessary implications and even preconditions of a workable discovery and learning process in society. As already Hayek (1946/48: 103) observed: "slow adaptation does by no means necessarily mean weak competition. When the variety of near-substitutes is great and rapidly changing, where it takes a long time to find out about the relative merits of the available alternatives ... the adjustment must be slow even if competition is strong and active ... competition is the more important the more complex or 'imperfect' are the objective conditions in which it has to operate". In a very similar vein Hirschman (1970: 85) argued that a certain amount of „loyalty“ helps to find the right responses to decline in firms, organizations and states, since it gives entrepreneurs (on markets as well as in politics) time to analyse the situation and convince citizens of the need for political reforms.

Especially with regard to responses to decline in states, the exit-signals have to be interpreted, and "voice" or public opinion, exploring reasons for decline and acceptable responses to it, has to be collectively formed and communicated. Since "voice" remains the decisive currency in democratic policies both extremely sensitive and instantaneous "exit" and extremely acquiescent "loyalty" (the relinquishment of exit-options) would obstruct critical collective learning processes: Extreme "exit" would lead to the sudden collapse of the community and

leave no dissenting voice behind; extreme “loyalty” would lead to paralysis of the community with no credible threat of “exit” to lead to political responses. Workable learning processes, in political as well as in economic organisations, are most likely to exist in situations where moderately loyal citizens can credibly threaten to “exit” if their “voice” is not heard.¹⁸

6. Institutional competition and its alternatives

In order to appraise the virtues of inter-jurisdictional competition, the adequate basis of comparison is not a state of affairs that can nowhere be realised. Instead of such a “Nirvana approach”, the adequate basis of comparison ought to be the consequences that would arise in the absence of competition (Hayek 1946/48: 100). Realistic alternatives to institutional competition are of two kinds:

- (1) Unilateral measures of local governments to prevent the “exit” of their citizens
- (2) Multilateral collusion to prevent competition by ways of harmonisation or centralisation.

Both the unilateral erection of artificial barriers to exit (or entry) and the multilateral cartelisation of would-be competitors, have similarly negative effects on potential discovery and learning in politics. Inside the isolated jurisdiction as well as among harmonised or centralised jurisdictions, all we can hope for and learn from are consecutive trials and errors. Institutional competition adds the very important dimension of parallel experimentation: the opportunity to compare and choose among real-world political trials¹⁹. As a consequence, only institutional competition allows for the continuous discovery and communication of citizens’ changing preferences and needs and the continuous reflection of local differences between informed preferences and tested capabilities.

At the same time, decentralisation and inter-jurisdictional competition are less risky ways to correct unavoidable errors. Inadequate harmonised or centralised policies are already less

¹⁸ Such conditions seem to be particularly well developed in Switzerland, with low legal barriers to exit to neighbouring Cantons in a highly decentralised federal system, combined with a system of direct democracy on the Canton-level which creates a substantial potential for citizens’ loyalty and responsibility (see Adamovich/Wohlgemuth 1999).

¹⁹ Solely in terms of variety, centralization and harmonisation are even more damaging to political learning than isolationism since the latter does not by itself reduce variety and hence the potential of “yardstick competition” based on empirical observations of comparative success or failure. In terms of liberty (our second major component of competition, see above) however, harmonization seems to be in most cases a less drastic infringement. It does not curtail the freedom to move and choose as such, it “only” reduces the alternatives from which one can choose.

easily identified due to the lack of comparable and selectable alternatives. Presumably this is rather often what inter-jurisdictional cartels had in mind in the first place. But even generally recognised fatal errors of harmonised or centralised policies are very hard to revise due to the complex log-rolling arrangements that created many internationally agreed, but obviously non-universalisable and collectively damaging policies (e.g. the EU's Common Agricultural Policy).

By comparison, a system of competing jurisdictions greatly improves both citizens' and politicians' knowledge base and their incentives to react to revealed shortcomings of present policies. The effects in terms of risk-control are obvious: with local experimentation on smaller scales the refutation of a social-political "hypothesis" is no fatal disaster. But if a large encompassing political union is forced to follow one grand idea or all-embracing political theory, its refutation or falsification implies large social costs or even catastrophe. The holistic social experiment of communism is a radical illustration of this point.

One does not have to refer to the end of history or the fate of most communist and many other totalitarian systems to demonstrate the merits of inter-jurisdictional competition. One can even admit that in many cases there are respectable arguments in favour of harmonisation. As an example, harmonised product norms can help reduce transaction costs and this, viewed in isolation, can foster efficiency and competition on product markets. Or quite generally one may prefer to forgo some potentials for competitive discovery on a higher level (say, by accepting common basic rules of the game of an internal market), if one can thus create more intensive competition on lower levels. Such arguments have been widely discussed in the classical anti-trust literature e.g. regarding standardisation cartels (e.g. Farrell/Saloner 1985; Blankart/Knieps 1993). The main problem is how to determine the trade-off between concrete and tangible advantages of some harmonisation from a static point of view (that is, the efficiency of given, present policies due to, e.g. economies of scale) on the one hand and a reduced potential for competitive discovery on the other. The tangible advantages are more easily modelled (which may be why mainstream economists like them), and they are more easily communicated (which may be why politicians like them).

What is less easily modelled and sold to the public is the inherent danger of standardised "one-size-fits-all" policies creating institutional path-dependencies that make a spontaneous adaptation to new environments, new preferences and new knowledge much more difficult

than it would be in the presence of freedom to develop and choose alternative policies. To be sure, institutional competition could also lead to a reduction of institutional variety. But there are two crucial differences between such unplanned (ex-post) harmonisation and deliberately arranged (ex-ante) harmonisation: First, ex-post harmonisation through competitive selection is the result of voluntary decisions of citizens whereas ex-ante harmonisation is often the result of barter and collusion between politicians holding coercive power. Second, ex-post harmonisation through voluntary and revocable choices leaves the option for decentralised units to (re-)introduce (new) political alternatives if they so wish, whereas ex-ante harmonisation by political compact does not. The costs and benefits of upholding such “potential competition” as well as those of its deliberate destruction, however, cannot be specified in much detail. This would presuppose that we already knew what we can only hope to learn through institutional competition.

7. Outlook: how far is Brussels from Athens?

Let me return to the opening quotation in which David Hume refers to the rivalry between Greek principalities and republics and argues that “nothing is more favourable to the rise of politeness and learning than a number of neighbouring and independent states connected together by commerce and policy”. Hume (1742/1985: 121) went on to claim that “Europe is at present a copy at large of what Greece was formerly a pattern in miniature”. More than 250 years after Hume wrote this down, Europe certainly looks very different. She saw the emergence of large nation-states often engaged in non-peaceful rivalry with disastrous results. With the advent of the European Community and the European Union, peace on the continent has been restored and more and more nation states were (once again) to be “connected together by commerce and policy”. This is no minor achievement, to say the least.

At the same time however, the political integration of Europe seems more and more to legislate away the richness of the European institutional landscape and the potential for learning and innovation that was once the secret of Europe’s dynamic growth of civilisation. With an “acquis communautaire” of over 90 000 pages of unified laws and regulations, and incessant demands by EU organisations and member state governments for “European solutions” – that is, centralised or harmonised institutional responses to social-economic problems – there is an imminent danger of the European Union degenerating into a political cartel for defending a European “social model” that nowhere exists as a common heritage and

that – in its variant as an overburdened welfare-state – has long lost competitive sustainability. Such a “model” or “European solution” could easily become a monolithic set of sclerotic institutions that politicians would like to protect. But institutional competition does not stop at the borders of the EU. If it is true that institutional variety and “mutual jealousy” were major causes of the “European miracle” (Jones 1981), present trends towards uniformity within the European Union are in danger of dampening learning processes and social progress on our continent.

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